

Brazil's oil problem

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If the fines levied against Chevron and Transocean are any indication, grandstanding may dash Brazil's dreams of becoming an oil exporting powerhouse. After all, Petrobras can't go it alone.



FORTUNE - Corruption, grandstanding and total incompetence may sink Brazil's dreams of becoming an oil exporting powerhouse. Prosecutors in the country last week slapped Chevron and drilling partner Transocean with an \$11 billion fine for accidentally releasing around 3,000 barrels of oil off of Brazil's coast. While the fine is clearly excessive and unlikely to stick, it has raised questions regarding the long-term safety of doing business in Brazil.

Oil spills seem to unfortunately be a fact of life when drilling and transporting oil from the ocean floor. Massive spills, like BP's disastrous four-million barrel belch in the Gulf of Mexico last year, though, are totally unacceptable. But the leaking of a few hundred barrels of oil per year seems to be par for the course when extracting millions.

In Brazil, though, one would think that such minute spills were a capital offense -- especially if the offender was a foreign oil company. US-based Chevron (CVX) was fined 50 million reais (\$28 million) by Brazil's federal government earlier this month for leaking around 2,400 to 3,000 barrels from one of its offshore drilling platforms located 75-miles off the coast of Brazil's iconic beaches in Rio de Janeiro.

The fine is around double what Chevron would have had to pay if the leak occurred in U.S. waters, and only if the company were convicted of gross negligence in relation to the spill. Instead of fighting the fine, Chevron agreed to pay, accepted total responsibility for the accident and quickly began clean up. It did not want to jeopardize its place in Brazil's fast-growing oil industry. The leak has since been plugged and has disappeared from the ocean surface. There was never any risk of oil washing up on the beaches in Rio given the size of the spill and the direction of the ocean currents.

But that was not the end of the story. The oil spill quickly became politicized in the state of Rio de Janeiro, home of Brazil's burgeoning oil industry and the quasi-state-controlled oil giant Petrobras. The environmental secretary of Rio threatened to revoke Chevron's operating license over the spill, sending shivers all the way up to Houston, home to the dozens of foreign oil companies that feed Brazil's oil engine. The federal government in Brasilia quietly reassured the oil community that drilling permits were under federal jurisdiction and that they should simply ignore the howls of discontent from local officials.

Petrobras: The next oil colossus

But now those howls have turned into a stinging civil lawsuit. Prosecutors from Campos, a city near Rio de Janeiro, filed suit last Wednesday against Chevron and Transocean (RIG) for gross negligence in connection with the oil spill. They announced they were seeking 20 billion reais or around \$11 billion in compensation for the spill. The fine was high, prosecutors say, in order to send a message that Rio was serious when it comes to environmental protection. The suit did not mention Chevron's other partners in the oil field, a Japanese financial company and Petrobras, and did not say how the fine would be divvied up between Chevron and Transocean.

The fine is equivalent to around \$3.5 million per barrel spilled and it dwarfs the U.S. maximum fine of around \$4,300 per barrel spilled. BP's (BP) total fine for dumping 4 million barrels into the Gulf of Mexico last year came to around \$3.5 billion, around a third of what Chevron is now facing with its 3,000 barrel belch.

But the jaw-dropping fine will probably never be paid. Chevron's total oil assets in Brazil are estimated to be worth around \$4.1 billion, according to an analysis conducted by Barclays. Chevron's Brazilian unit would probably declare bankruptcy before it shelled out one real to the Rio government. Egregious fines are becoming more common these days in the oil world. They are usually levied by corrupt states like Venezuela and Kazakhstan as a form of blackmail in order to extract more money from oil companies once they start production. They are also used as an excuse for a state takeover of oil assets.

Overzealous prosecutors

Brazil has had a somewhat fair record in dealing with its foreign partners up until this point. It has actually encouraged foreign participation from oil giants like Exxon Mobil (XOM), Shell, Chevron and BP in its offshore oil business as a way of quickly ramping up production as Petrobras (PBR) had neither the money nor the expertise in doing it alone. The country wants to double its oil production capacity by 2020 to around 7 million barrels a day. That would make Brazil the third-largest oil exporter in the world behind Russia and Saudi Arabia.

Brazil's federal system now has become a liability in that quest. The federal government wants to distribute more of the oil royalties evenly across all the states in Brazil, instead of the lion's share going to states on the coast where the drilling occurs. Rio has been a major critic of the plan as it stands to lose an estimated \$7 billion over the next few years in oil royalties. Cities like Campos and Rio had already earmarked that money for grand projects, most notably, for the 2016 Olympic Games.

Why BP (and Big Oil) just can't lose

The prosecutors in Campos are sending a message to Brasilia that it should tread carefully if it tries to take its oil money away. If it is successful in driving Chevron out of the country, Brazil's dreams to be the preeminent oil exporter in the western hemisphere would sink to the bottom of the ocean. Foreign oil companies would refuse to dish out any more money to develop the country's resources if it knew that it could be kicked out at any moment by overzealous prosecutors in small towns.

Brazil needs the technology, equipment and expertise of foreign oil companies if it hopes to grow its oil industry. An estimated \$600 billion will be needed over the years to get its newly discovered mega fields into production. Brazil also needs them to just maintain production. For example, Transocean alone operates 10 of the 60 offshore oil platforms currently in operation in Brazil.

Petrobras depends on foreign oil giants and contractors to do the lion's share of its work for them offshore. Foreign engineers that have worked in Brazil complain about the incompetence of their Brazilian counterparts. Last year, Petrobras reported 57 oil leaks that released 4,201 barrels of oil into the ocean, far more than Chevron's infringement last month (and not surprisingly, Petrobras reported significantly smaller fines -- only \$43 million in 2010). And this is, after all, the company that in 2000 "accidentally" sank the world's largest oil platform at the time just a few months after taking ownership of it. The billions of dollars that went down the drain in that incident convinced Brazil that it needed foreign help if it ever hoped to become an oil exporting powerhouse.

But the memories of that oil disaster seem to have faded in Brasilia. Petrobras's participation in the ultra-deep water oil business remains mostly passive and is viewed by the oil industry as another form of royalty payment to the state. But under a new law passed last year, Petrobras must now have a minimum 30% stake in any new oil ventures connected with the newly discovered mega "pre-salt" offshore fields.

If Brazil hopes to grow its oil industry it will need the technology and equipment of foreign oil companies. It has already irked many of them by forcing them to turn over more of their future profit to Petrobras. But the threat of mega fines eating away at the rest of their profits will make many stay home.

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